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No. 03-1688

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IN THE

Supreme Court of the United States

PT PERTAMINA (PERSERO), F/K/A PERUSAHAAN PERTAMBANGAN MINYAK DAN GAS BUMI NEGARA,
Petitioner,

v.

KARAHA BODAS COMPANY, L.L.C.,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

REPLY BRIEF

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Petitioner PT Pertamina (Persero), f/k/a Perusahaan Pertambangan Minyak Dan Gas Bumi Negara ("Pertamina"), respectfully submits this reply in further support of its Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit ("Pet."), and in response to the Brief for Respondent in Opposition to Petition for Writ of Certiorari ("Opp.") served by Karaha Bodas Company, L.L.C. ("KBC") on August 6, 2004.

ARGUMENT

Article V(1)(d) of the New York Convention protects against enforcement of an international arbitration award when "[t]he composition of the arbitral authority . . . was not in accordance with the agreement of the parties." The New York Convention is implemented via Chapter 2 and, except where inconsistent, Chapter 1 of the Federal Arbitration Act ("FAA"). The international arbitral tribunal here was not selected in accordance with the plain terms of the parties' arbitration agreements. Nevertheless, applying a deferential standard of review, the court below allowed the resulting award to stand.

In its petition, Pertamina showed this decision conflicts with well-established law under the FAA in four other circuits that contractual methods for selection of arbitrators must be strictly enforced and that an arbitrator's construction of such contractual provisions is not entitled to deference from the courts. This conflict concerns a recurring and important issue that cuts to the core of arbitration—its dependency on and limitation by the consent of the parties. The Opposition does not undermine these contentions and instead highlights the propriety of granting the petition in this case.

First, there is an actual conflict. The court of appeals' parroting of the arbitrators' analysis, on which Respondent relies, does not constitute independent evaluation of the arbitration clauses, and the court's enforcement of the contrived method of selection used in this case conflicts with the strict conformity demanded by the majority rule. *See Avis Rent A*

Car Sys., Inc. v. Garage Employees Union, 791 F.2d 22, 25 (2d Cir. 1986) ("Courts generally enforce [arbitration clauses] strictly, vacating awards entered by arbitrators whose qualifications or method of appointment fail to conform to arbitration clauses.").

Second, nothing in this Court's *Green Tree* decision undermines the strength of the decisions from the other circuits. To the contrary, the issue presented here—who gets to decide whether the arbitrators were properly appointed—is much like the gateway question held to be for the courts, not the arbitrators, in *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 944-45 (1995). It concerns fundamentally ***who*** will decide the parties' dispute, and, unlike the class action question in *Green Tree*, not merely "***what kind of arbitration proceeding*** the parties agreed to." *Green Tree Financial Corp. v. Bazzle,* 539 U.S. 444, 452 (2003) (emphasis in original). That the case also involves the New York Convention provides an additional reason to grant the petition, not deny it. The law under Chapter 1 of the FAA is fully consonant with the New York Convention's stricture to decline enforcement of an award issued by arbitrators not selected in accordance with the parties' agreement. Uniformity and consistency are important. *See Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 520 (1974).

Third, if the arbitrators were not properly selected, as we contend, then the award should not be enforced, as specified in Article V(1)(d) of the New York Convention. Respondent's contrary contentions are makeweights that are readily discarded.

1. Respondent cites no authority—not under the New York Convention nor under the FAA—for courts to defer to arbitrators' determinations of the propriety of their selection or for anything other than rigorous enforcement of arbitrator selection clauses. Rather, both *Cargill* and *Avis* are explicit that no deference is due the arbitrator's own interpretation of the selection clause and that strict adherence is required. *Cargill Rice, Inc. v. Empresa Nicaraguense Dealimentos Basicos*, 25

F.3d 223, 226 (4th Cir. 1994) (arbitrators' "interpretation would not be entitled to deference"; deference "appears impossible because the determination of how they should be selected obviously had to precede their selection"); *Avis*, 791 F.2d at 25 (courts should "generally enforce [arbitration clauses] strictly"; "arbitrator had no authority to interpret"). *See also Szuts v. Dean Witter Reynolds, Inc.*, 931 F.2d 830, 831 (11th Cir. 1991) (rejecting decision of two arbitrators following removal of third when agreement required the arbitration to "'be before at least three arbitrators'"); *Hugs & Kisses, Inc. v. Aguirre*, 220 F.3d 890, 893 (8th Cir. 2000) (when agreement required parties to negotiate selection in good faith, court rejected award made by arbitrator selected by one party when other party ceased participation; remedy is selection by court, not unilateral selection by one party).

Respondent acknowledges, as it must, that there is such precedent. It does not dispute that both the arbitral tribunal and the court below acknowledged that the ESC by its terms required that KBC and Pertamina jointly appoint an arbitrator, Pet. App. 32a, 194a-195a, yet they required instead that Pertamina and PLN (and the Government) make a joint appointment.[1] Respondent nonetheless contends that there is no conflict, however, because either (a) the court of appeals did not articulate the standard of review pursuant to which it was operating, or (b) the court of appeals actually engaged in a *de novo* review of the arbitrator selection clauses. Opp. at 20-22. Neither proposition is tenable.

At the outset, Respondent short-quotes the Petition in asserting that we agreed that the Fifth Circuit did not suggest

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[1] That the Government was later dismissed as a party does not negate the fact that when KBC initiated the arbitration it purported to require Pertamina to appoint one arbitrator jointly with PLN and the Government, and that the ICSID Secretary General made such an appointment for them. Neither the arbitrators nor the courts below ever tried to explain how such a ***triple*** joint-appointment satisfied any of the parties' agreements. *See* Pet. App. 193a (disregarding role of Government since it had been dismissed).

that it was deferring to the arbitrators. Opp. at 21 & n.15. The point made by the remainder of the quoted sentence is that the court did not adopt a distinct *de novo* standard "***for its assessment of the propriety of the selection of arbitrators*** under Article V(1)(d) of the Convention," Pet. at 14 (emphasis added), as it should have. Rather, the court applied the highly deferential standard it applied to review of ***all*** of the award: "The court may not refuse to enforce an arbitral award solely on the ground that the arbitrator may have made a mistake of law or fact. 'Absent extraordinary circumstances, a confirming court is not to reconsider an arbitrator's findings.'" Pet. App. 15a. Because the Fifth Circuit applied this deferential standard, and not the strict *de novo* review required under the case law of the Second, Fourth, Eighth, and Eleventh Circuits, there is a clear conflict.

Further, what Respondent contends was *de novo* review was simply a regurgitation of the tribunal's interpretation of the arbitration clauses, capped by the court's conclusion that the tribunal's interpretation was "reasonabl[e]." Pet. App. 32a-33a. The one example of supposed independent review Respondent stresses, Opp. at 18-19, 21, demonstrates how far off course the Fifth Circuit strayed in deferring to the arbitrators. The court's conclusion that strict application of the arbitration clause would allow Pertamina to block arbitration flies in the face of the express terms of the contract, as explained in the Petition at 14, 21, and not contested by Respondent—KBC could have asked the ICSID Secretary General to make a joint appointment for itself and Pertamina, as the ESC required, rather than foisting a joint appointment on Pertamina, PLN, and the Government. By deferring to the arbitrators and failing to require strict adherence to the agreed methods for selection of the arbitrators, the court below created a conflict with the four other courts of appeals.

2. Respondent's arguments based on *Green Tree* are spurious. The court below, of course, decided this case after *Green Tree* was decided, and after Respondent relied on it, but the court did not rest its decision on or even cite the case. Conversely, there is nothing in *Green Tree* that should cause the four circuits that have demanded *de novo* review and strict application of arbitrator selection clauses to change their views. As explained in the Petition and not addressed in the Opposition, there are powerful reasons to conclude that arbitrator selection is precisely the sort of gateway issue that should be decided by the courts, not arbitrators: (a) whether the arbitrators were properly appointed necessarily is a question antecedent to their authority to act, and therefore there is no basis to defer to their interpretation; (b) Article V(1)(d) of the New York Convention specifically leaves it to the reviewing court to determine whether the arbitrators were appointed in accordance with the contract; and (c) leaving it to the arbitrators to determine the propriety of their appointment risks allowing the decision to be compromised, even unintentionally, by the arbitrators' self-interest, more so than virtually any other gateway issue. *See* Pet. at 18-20. The arbitrator selection question concerns quite literally ***who*** will decide the case, not simply what kind of proceedings will be conducted, *see Green Tree*, 539 U.S. at 452, and thus is one that the parties' must be expected to have understood the courts would ultimately decide, within the framework established by this Court. *See Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79, 83-84 (2002); *First Options*, 514 U.S. at 944-45. That the court below deviated from the other circuits whose precedent conforms to this teaching, even after *Green Tree*, provides no basis to conclude that *Green Tree* will lead to resolution of the conflict—quite the contrary.

The Opposition notes that the cases from the other circuits with which the ruling below conflicts were decided under Chapter 1 of the FAA, not under the Convention as codified

in Chapter 2, but Respondent provides no reason why that should matter here. *See* Opp. at 26-27. Chapter 2 specifies that "Chapter 1 applies to actions and proceedings brought under this chapter to the extent that chapter is not in conflict with this chapter or the Convention as ratified by the United States." 9 U.S.C. § 208; *see* Pet. at 4. As discussed in detail in the Petition at 17-18, and not addressed in the Opposition, Chapter 1 of the FAA and the New York Convention are perfectly consonant in insisting that the arbitrators must be selected as specified by the parties. There is thus no reason why the case law developed under Chapter 1 for determining when and how a court should decline enforcement of an award for failure to abide by the parties' agreed selection method should not apply equally to a Convention case under Chapter 2. *See China Minmetals Materials Import & Export Co. v. Chi Mei Corp.*, 334 F.3d 274, 289 (3d Cir. 2003) (applying *First Options* requirement of *de novo* review to defense under Article V of the New York Convention).[2] Granting the petition to resolve the conflict is all the more important because it would contribute to the uniformity and consistency that is the objective of the Convention. *See Scherk*, 417 U.S. at 520.

3. The Opposition concludes with a hodgepodge of unsupported arguments for denying review, none of which can be sustained. First, Pertamina did not waive its defense. KBC

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[2] Contrary to Respondent's allegation, Opp. at 19 n.14, 27, Pertamina argued to the court of appeals that its Article V(1)(d) defenses must be decided *de novo*, and Pertamina repeatedly cited and relied upon *Brook v. Peak Int'l, Ltd.*, 294 F.3d 668 (5th Cir. 2002), which cited and relied upon *Cargill* and *Avis*, among others we have cited, for the proposition that courts generally enforce selection clauses strictly and deny enforcement when the appointment is non-conforming. *Brook*, 294 F.3d at 673. It should have sufficed to cite the Fifth Circuit to its own precedent that appeared to accept the majority rule without having to cite that authority separately. As it turns out, the Fifth Circuit's acceptance of those cases was more apparent than real, leading to the conflict presented here.

concocts of whole cloth a "strategic" reason for Pertamina and the other arbitration respondents to have declined to select an arbitrator, Opp. at 28-29, but the record shows that they were motivated by their view that the arbitration was improperly initiated and that the procedure was not in conformity with the parties' agreements, *see, e.g.*, Pet. App. 161a, 178a-180a, 191a. They presented these arguments to the tribunal as soon as it was constituted, which the tribunal found to be appropriate and timely. *See* Pet. App. 192a-193a. The Fifth Circuit did not hold there was a waiver, but even if it did, such a subsidiary holding could not independently support the judgment, both because the tribunal had rejected the argument, which is binding, *see* Pet. at 10, 21-22, and because waiver could not be found here consistently with this Court's or circuit precedent. *See First Options*, 514 U.S. at 946 (gateway issue presented at hearing was timely); *Brook v. Peak Int'l, Ltd.*, 294 F.3d 668, 674 (5th Cir. 2002) ("objections to the composition of arbitration panels must be raised 'at the time of the hearing'") (citation omitted); *Avis*, 791 F.2d at 26 (challenge to panel presented at hearing timely); Pet. at 22.

Second, resolution of the arbitrator selection issue in Pertamina's favor would necessitate declining enforcement of the award. A single award was issued by a single improperly convened tribunal that, at KBC's insistence, heard claims under two different contracts. Under the procedure KBC adopted, and the arbitrators and courts sanctioned, KBC was allowed to choose one arbitrator, while Pertamina, PLN, and the Government were required jointly to select another. None of the arbitration agreements provided for such a joint appointment by the three entities.[3] The impropriety of the

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[3] As to the UNCITRAL Rules, Opp. at 10 n.5, 24, the arbitrators recognized that the procedure provided in them could not apply directly here, Pet. App. 196a, and Pertamina has consistently argued that the specific selection methods in the parties' agreements trump those rules, Pet. at 23, which both *Cargill* and *Szuts* support. *See Cargill*, 25 F.3d at 226 n.6

selection under the ESC thus infused the selection under the JOC, too, and tainted the entire proceeding and resulting award. Under Article V(1)(d), enforcement of the unitary award should be denied.

Finally, Respondent's argument about lack of prejudice is just silly. The Fifth Circuit admittedly did not adopt it, Opp. at 29, and none of the cases require such a showing as to improper arbitrator selection. To the contrary, *Avis* places the burden on the party seeking a variance from the agreed selection procedure. *See Avis*, 791 F.2d at 25-26.

There is good reason why a particularized showing of prejudice is not required. The prejudice is self-evidently inherent, given the critical function of arbitrator selection and party participation in it. "That ***selecting the tribunal is the most important decision to be made*** in any international arbitration (apart from the rendering of the actual award) is, by now, cliché. It also still happens to be true." Gerald Aksen, *The Tribunal's Appointment* in THE LEADING ARBITRATORS' GUIDE TO INTERNATIONAL ARBITRATION 31 (L. Newman & R. Hill eds. 2004) (emphasis added). "The essence of arbitration—that which distinguishes the process from court adjudication—is freedom of choice. . . . ***Choosing an arbitrator*** or arbitration tribunal ***is the most important decision facing parties in commercial arbitration*** . . . ." COMMERCIAL ARBITRATION AT ITS BEST 67 (T. Stipanowich & P. Kaskell eds. 2001) (emphasis added). The selection of arbitrators is "probably the single most important stage in the proceedings," and the role of the party-appointed arbitrator is

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(holding that rules of administering body could not be followed because they conflicted with the parties' agreed selection method); *Szuts*, 931 F.2d at 831-32 (specific method agreed by the parties takes precedence over any arbitration rules adopted by reference). In any case, the UNCITRAL Rules do not insulate the tribunal's gateway decisions from *de novo* review under *First Options*. *See China Minmetals*, 334 F.3d at 287-89.

to ensure "that the appointing party has its positions fairly considered." Carolyn Lamm & David Rivkin, *International Disputes* in ALTERNATIVE DISPUTE RESOLUTION 307, 317-18 (N. Atlas, S. Huber, E. Trachte-Huber eds. 2000). Because of this, everyone understands that interference with the agreed-upon selection method is prejudicial – which is why it is a defense under Article V(1)(d) of the New York Convention. Moreover, proving actual prejudice, as Respondent insists, would require "an ***impossible*** showing . . . that the complaining party would have obtained a more favorable award from the properly selected arbitrator than the award actually rendered by the improperly selected arbitrator." *Brook v. Peak Int'l, Ltd.*, 169 F. Supp. 2d 641, 647 (W.D. Tex. 2001) (emphasis original), *rev'd on other grounds*, 294 F.3d 668 (5th Cir. 2002).

4. There is no merit to the Opposition's insinuation that, merely by resisting the award and petitioning this Court, Pertamina is acting illegitimately. It is well recognized that a party against whom an international arbitration award has been rendered need not seek judicial relief proactively but may interpose its New York Convention defenses to the prevailing party's enforcement efforts. *See, e.g., Paklito Investment Ltd. v. Klockner East Asia Ltd.*, [1993] 2 HKLR 39, 48-49; ALAN REDFERN & MARTIN HUNTER, LAW AND PRACTICE OF INTERNATIONAL COMMERCIAL ARBITRATION 487 (3d ed. 1999).[4] That is what Pertamina has done here.

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[4] The Central Jakarta District Court granted Pertamina's petition to set aside the award on a variety of grounds, including that the tribunal was improperly constituted. *See* TSR. 3109-3100. The Brief for the Republic of Indonesia as *Amicus Curiae* in Support of the Petitioner amply demonstrates why the Indonesian court's judgment should have been given effect under Article V(1)(e) of the Convention. The comity concerns expressed in that brief bolster granting the petition to provide relief under Article V(1)(d).

That the award is fundamentally unsound is well documented. *See* Louis Wells, *Double Dipping in Arbitration Awards? An Economist*

Meaningful judicial review of the award, as should be assured by the New York Convention, is a "necessary safeguar[d]" to ensure that the award and the procedures giving rise to it do not offend the parties' arbitration agreement, due process, or public policy. *M&C Corp. v. Erwin Behr GmbH*, 87 F.3d 844, 847 (6th Cir. 1996).

Moreover, contrary to Respondent's assertion, Opp. at 1, the Petition presents a sharply focused, well-developed issue of general importance that is neither fact-bound nor remote – whether arbitration selection clauses must be enforced strictly via *de novo* review. This goes to the core of party consent, which is the foundation of arbitration. As a recent, post-*Green Tree* decision has aptly held, violation of the agreed-upon arbitrator selection method "may transform a fair and efficient adjudicative proceeding into a sham trial . . . [and] destroy the legitimacy of the entire arbitration proceeding." *Encyclopedia Universalis, S.A. v. Encyclopedia Britannica, Inc.*, 2003 WL 22881820 at *1 (S.D.N.Y. Dec. 4, 2003). That is what happened here. Such a fundamental violation, sanctioned in conflict with the holdings of four other circuits, is indeed important and warrants this Court's review.

CONCLUSION

For the foregoing reasons and those stated in the petition, the petition for writ of certiorari should be granted.

Questions Damages Awarded to Karaha Bodas Company in Indonesia, 19 ARB. INT'L 471 (2003). The *Himpurna* and *Patuha* awards, Opp. at 12 & n.8, offer no support. They refused lost profits for generating capacity not yet constructed or being built, R.1407-1406, R.1399, R.1431, R.1424-1423, as is the case here, and considered doing so "would be like stepping on the shoulders of a drowning man." R.1399. The Opposition is unmoored in claiming even that construction financing had been committed, Opp. 11 n.7; all KBC claimed was that a shareholder was prepared to finance the project. *See* Pet. App. 7a, 248a.

Respectfully submitted,

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